RICHARD RUSSELL'S **Dow Theory Letters** INCORPORATED

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THE PICTURE: On the front page of the July 29 *New York Times* there appeared the headlines, **"A Plunge in Profits Is Raising Risk For the Stock Market and Economy."**

And the reaction by sophisticated market practitioners to the *Times* headline was probably, "Forget about it — the 'plunge in profits' that the *Times* is talking about is history." The stock market doesn't care about "yesterday's" plunge in profits — the market is only interested in the business picture as it will be — six months or even a year from now.

And the Russell comment to the above is: All very true – if you're in a bull market. But in a bear market, where the primary trend of the stock market and the economy is DOWN, the plunge in profits is indeed important, because **in a bear market declining corporate profits feed on stock prices, and in turn, declining stock prices feed on declining corporate profits.** Today's investors are basing everything on the widely expected upturn in the economy that lies just ahead. But that upturn may, or may not, materialize.

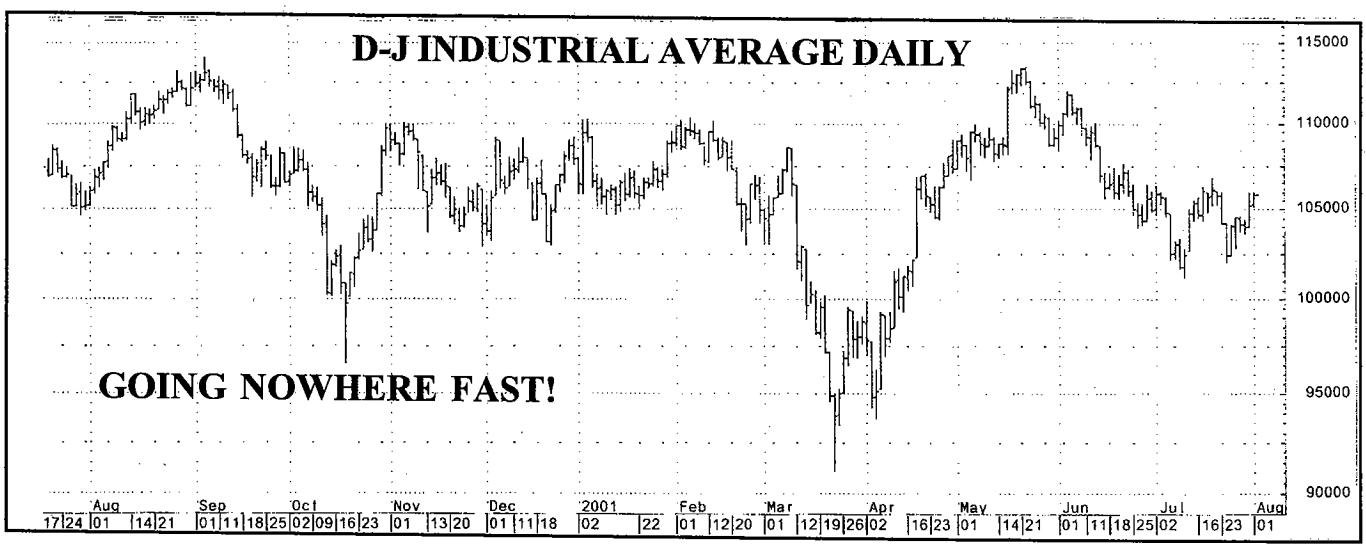
July 20, 2001, DJIA 10576.65; PTI 5321; A-D Ratio -2.47
July 27, 2001, DJIA 10414.50; PTI 5327; A-D Ratio -2.48
August 3, 2001, DJIA 10512.78; PTI 5340; A-D Rato -1.92
Dow yield: 1.70; Dow p/e: 25.93
Gold 50-day MA: 269.50

Remember the old adage, "In a bear market nothing works." The adage should read, "In a bear market nothing works the way it does in a bull market."

In other words, the "plunge in profits" that the *New York Times* was referring to is really quite bearish. It's bearish because it is part of a **continuing chain of rotten news** that will emerge as this bear market moves on – and on – and on.

Right now the entire investment community is waiting for the "inevitable upturn which lies ahead." Sure there's an upturn ahead, but that upturn lies very far ahead, much further than today's optimists are thinking about. First, before the upturn can materialize, we're going to go through the various stages of a primary bear market.

This entails an extended, often surprising, often tedious decline, a decline which will take business and the market to much lower depths. The sporadic bear market rallies will be just that – technical corrections



that will not have much to do with the economy. Furthermore, the fact that market rallies will not have much to do with the economy will also be demoralizing. They will lead to many false expectations.

The bear market will have to go through its stages and phases before we can expect that long awaited upturn. Unfortunately, almost all the analysts and strategists of today lack any experience with primary bear markets. In waiting for the upturn, the analysts are "whistling in the dark." We haven't had the full bear market yet. That lies ahead.

But what of the Fed's action in flooding the system with liquidity and dropping rates, and dropping rates again, and dropping rates still again? The Fed's action would be explosive if this was a bull market. In a primary bear market, all the Fed is doing is **extending the bear market**. It's just going to take longer before this bear market arrives at its inevitable bottom.

Last week I received the following e-mail from a subscriber, "Richard, my question is — what needs to happen for you to reverse your bearish stance? Regards, John M."

My answer to the question is that I'd have to see stocks at "great values" before I turned bullish in a major or long-term way. Of course, getting to great values would involve a process, and I can see that although you are sincere, you don't understand the process at all.

First, you have to understand that we're in a primary bear market now. So your question is like asking the battered and bleeding victim of a terrible car wreck, "What would it take for you to feel great?"

The obvious answer is that it's going to take time, a lot of time and a lot of treatment. There's no magic day next week or next month when the victim is going to feel great. This victim has to **go through the process** of getting over shock, of healing, learning to walk again, maybe psychological treatment — just a long series of treatments that will probably take two or three years.

Going back to the stock market, we're currently in the early second phase of a primary bear market. The first phase entailed the market's erasing the foam and froth of the preceding bull market top. We saw that occur when the Nasdaq collapsed and when the fantasy of the dot-coms fell apart.

The second phase, which is where we are now, is generally the longest phase of a bear market. In the second phase stocks go down in reaction to the deterioration in corporate earnings. The second phase of a bear market is characterized by many gaps and air holes in stocks as the bad news emerges. We may see one to a number of panics during the second phase, as the market reacts to shocking or unexpected news.

Following the second phase we have the third phase. This is the "desperation" or "give up" phase when shell-shocked stockholders dump their shares for whatever the market will bring. During the third phase the investment-grade blue chip stocks are jettisoned, since the market has become so demoralized that the only market (liquidity) there is — is for the highest-grade blue chip stocks.

It's in the third phase that stocks sink to what Dow Theorists term "great values." Great values in the past have been characterized by the Dow selling at anywhere from 6 to 10 times earnings while yielding 6% or more on a dividend basis.

So in answer to the question, "What needs to happen for you to reverse your bearish stance?" What needs to happen is for the bear market to run its course to conclusion and for stocks to decline to the point where they become "great values."

Next Question: Russell, what makes you think that we'll ever see anything like the third phase you describe above? After all, this is a different world, it's

not even like the world of the early 1970s (during 1974 we saw a bear market's third phase and we saw stocks sink to the point where they had to be considered "great values").

Answer: Nothing is written in stone where the stock market is concerned. However, in predicting that this will be a classic bear market, I'm depending on thousands of years of what we know of human nature. Even the Bible talks about the "seven fat years" and the "seven lean years." Charles Dow talked about the swings from extreme optimism to abject pessimism.

So has human nature changed here in the year 2001? Maybe, but I sincerely doubt it. So saying, this might be a good time to include a thought introduced by Charles H. Dow at the turn of the century. It's an observation that has been borne out by history ever since. Dow wrote:

There is always a disposition in people's minds to think the existing conditions will be permanent. When the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this one which make it unlike its predecessors and give assurance of permanency. The one fact pertaining to all conditions is that they will change.

INVESTMENT POSITION:
You guessed it; the bear remains in the box.

This is still a primary bear market, and a dangerous market. One major danger is that the dollar has probably topped out. With foreigners holding huge amounts of US securities (for instance, they hold over 36% of all outstanding Treasuries) any sustained weakness in the dollar could start heavy foreign selling. The results could be additional pressure on both the US bond market and the US stock market.

The safest position at this point is probably Treasury bills or perhaps two-year T-notes. The problem with bills and notes, however, is that they provide very little in the way of income. So buying bills and notes would mean trading safety for yield.

This presents a very difficult situation for investors. Personally, I don't have the ultimate answer to "what to do." There used to be an old expression, "Take a chance, Columbus did." And I guess it all boils down to – whatever you do in this business, you're taking a chance.

I'm taking a chance with muni bonds. Of course, they'll get hit if bonds get hit. But in the mean time, I'll be collecting tax-free interest. What the hell, there's a limit to how safe you can be and how much you are willing to worry.

What about hedging against the dollar? One way would be to buy CDs denominated in euros. Another way would be to buy euro futures.

EXTENDED: Under Dow Theory a bull market ends at the point where the Industrial Average and the Transportation Average record their **last joint highs.** The great bull market of 1982 to 1999 lasted 17 years. The bull market **ended on May 12, 1999** – that was the last day that the Dow and the Transports recorded highs **together**. Although the Dow continued to advance, May 12, 1999 marked the bull market high for the Transports.

The 17-year bull market was by any measurement the **longest** bull market on record. In the course of the bull market we saw stocks rise to their most extreme valuations in history amid history's greatest volume and along with the greatest public participation in the annals of Wall Street.

Following the May 12, 1999 joint high in the Dow and the Transports, the Dow continued on — to an all-time high of **11722.98** recorded on January 14, 2000. From there the Dow, in an initial bear market leg, corrected down to a low of **9389.48** on March 22, 2001. From there, the market worked generally higher.

Bull markets tend to be followed by bear markets that last anywhere from 25% to 50% as long as the preceding bull market. The greater the bull market, the more probable that it will be followed by a typical bear market. This is logical simply because the bigger the bull market, the more there is to correct.

Therefore, following the 17-year bull market of 1982 to 1999, we might expect a bear market to last approximately four to six years. The Dow decline from January 2000 to March of 2001 lasted only 14 months or slightly over one year. During that decline stocks never returned to anything remotely resembling classic bear market values. In fact, stocks have remained at valuations well above any that existed at previous bull market tops. On this basis, it's hard to believe, as many claim, that the "bear market" is over.

I've held all along that this bear market would have many similarities to the 1966-74 bear market. For those subscribers who were not with me in 1966 to 1974, I want to present a brief review of those difficult years – refer to the chart.

The Dow hit a peak in February of 1966. From there the Dow broke to a low in October of 1966. Next we saw a highly speculative mini-bull rise to December of 1968.

From the '68 high, we saw a mini-bear market that carried the Dow to a new low in May of '70. Following the '70 low, the Dow rallied to a new high in January of '73, but here the Transports failed by a wide margin to confirm. Also, the advance-decline ratio had topped out in April 1971.

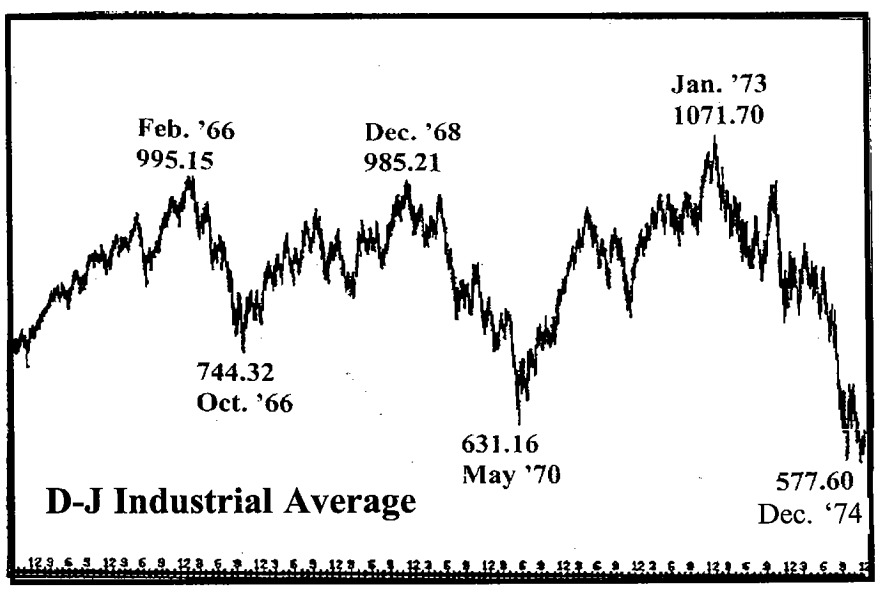
Following the January '73 peak, we experienced one of the worst market collapses since the '30s. The Dow ended its decline in December of 1974 at 577.60. Transports sunk to a low of 125.93. It had been a very deceptive and disastrous bear market

Interestingly, it was the Transportation Average that tipped the market's hand at the '73 Dow high (Transports refused to confirm the new Dow high) and again it was the Transports that provided the evidence of the bear market bottom in late 1974 (Transports refused to confirm the December low in the Dow).

As matters now stand, the Dow has been locked in a trading range (I believe it's actually a huge top) for well over two years. Earlier this year, it was the Transports that refused to confirm the superior action of the Dow. But more recently, it's been the Dow that failed to confirm the action of the Transports as the Transports rallied above their May closing high.

However, it's been the advance-decline ratio that has provided the real hope for the bulls. But the A-D action should be examined from a long-term perspective.

From its long decline beginning in April of 1998 to its



low record in March of 2000 the advance-decline ratio lost about 23 points. The rally from the March 2000 low to the present recouped about 23% of the 1998-2000 losses. Based largely on this normal recovery, the bulls have remained optimistic.

Speaking of advance-declines, I also run an advance-decline line of just the thirty Dow Industrial stocks. The A-D line for the Dow has been collapsing, which means that a select and limited group of Dow stocks has succeeded in holding the Dow within its trading range (I call it a top) of the last two years.

As long as the breadth in the Dow continues to be this dismal, I believe we won't see any new highs in the Dow. There are just too many of the thirty Dow stocks that are acting poorly. It's a fascinating picture, but I believe it's all part of one of the greatest distribution areas in stock market history.

NOTES & QUOTES: The following is from old friend Charles Allmon's *Growth Stock Outlook* (PO Box 15381, Chevy Chase, MD. 20825). "Now a great accounting battle rages. The chips are golden indeed ... Maybe another $5 trillion of vaporized wealth, with important social tremors which will be felt around the world. This service in recent years published considerable comments on manipulation of company data (apparently all legal) by hundreds of companies to meet Wall Street expectations and directly influence stock prices. A common villain, of course, is stock options, those ubiquitous pieces of paper scattered like confetti in lieu of cash wages, but the cost ignored. The list goes on and on.

"Even the former head of the SEC apparently lost a running battle to clean up the accounting profession. Questionable accounting practices, unthinkable in years past, now flourish in the S&P 500 companies, the Fortune 50, anywhere you care to look. What might cause the Dow and the S&P 500 to fall 15% to 25% in a week? My candidate would be a commission appointed by Congress, with Warren Buffett as chairman, to set strict accounting standards. Buffett reminds us that more money is stolen with a pencil than with a gun. Money talks in Washington. It always will."

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The emphasis on money and making money is probably at its strongest now in US history. In fact, the newest problem for therapists seems to be chronic gambling addiction. Family break-ups, crime, psychic collapses are all increasing as the gambling craze sweeps the nation as never before.

In California alone within a few years there will be around one hundred Indian Casinos, and this is worrying Las Vegas. In defense, Las Vegas is turning into a combined gambling mecca and vacation resort, a place to take the family while dad or mom plays 21 or craps.

The emphasis on gambling has actually decreased in Las Vegas, with food and entertainment rising in importance. Also rising are prices. Gone are the superbargain prices. Expensive restaurants are springing up everywhere, the dinner buffets now cost $8 and up, shows cost $40, $50 and up, and hotel rooms in season are pushing considerably higher in price.

Personally, Las Vegas is not my cup of tea. If you don't gamble (and I don't) there's little to do. Newspapers are hard to find, the crowds are stifling, and the sight of thousands of people "gaming" is as close to mindless as anything you're ever likely to see.

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At the gym we hear and talk to many local La Jolla brokers, brokers from a good many different firms (La Jolla has offices from every major brokerage firms). From what I gather, brokers are "dead," with most of them down 50% or more in business.

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Donald Morris's always fascinating *Donald R. Morris Letter*, 1-800-441-9837 (comes out weekly) is loaded with info. I thought the following was interesting.

But all conflicts, wars and battles, fade from living memory; in the end there is a 'last survivor,' not to mention the widows and offspring of veterans, who may continue to receive pension payments long after the last veteran has died.

There was fighting in the American Revolution from 1776 to 1782, even after Cornwallis had surrendered at Yorktown. The last survivor was Daniel T. Blakeman, who died in 1869, aged 109. But one veteran, who had been a drummer boy at Valley Forge, sired a daughter in 1843 when he was in his eighties. She died in 1943, the last true 'Daughter of the American Revolution.'

The last survivor of the War of 1812 died in 1905, aged 105. The last surviving widow, when 19, had married a veteran in his seventies; she died in 1938 (having drawn a pension for 53 years – totaling $262 for each of the 54 days her husband had served.). But a daughter of a veteran who had fought in the Battle of New Orleans (1815) also sired later in his life, drew a pension until her death at 88 in 1946 – when Washington was finally able to close the books on the costs of the War of 1812.

The last survivor of the 1854 Charge of the Light Brigade, Trumpeter Kenneth Lamphrey, died in 1926; in 1890 he had recorded a phonograph record for Thomas Edison, sounding 'Charge!' on the same bugle he had used at Balaklava (and which his regiment had used at Waterloo in 1815).

The last Union soldier of the Civil War (1861-65), Albert Woolson, died in 1956, aged 109. The last Confederate, Walter Williams, died in 1959, aged 117.

The last survivor of the 147 men who had defended Rork's Drift in 1879 against 4,000 Zulus was Colour-Sergeant Frank Bourne, who died in 1945 at the age of 91. He had enlisted in 1872, and been promoted to Colour-Sergeant in little more than three years – an astonishing feat at the time. He was commissioned Honorary Lieutenant in 1890, served in the 1st World War and had risen to Lieutenant-Colonel before his death.

While 212 men of the 7th Cavalry died with Custer on the Little Big Horn in 1876, members of detachments of the regiment, who had been with him that morning and ordered to proceed by different routes to the Indian village he was attacking – Reno's and Benteen's forces and men left in the camp that morning did survive. The last of these was Private Jacob Horner (left his camp because he had no horse); aged 96, he died in 1951. (The only survivor of Custer's band was Captain Keogh's gelding Comanche – who was never ridden again and died in 1891, aged 28). The last known Indian survivor was Chief Iron Hail, an Oglala Sioux who died in 1955, aged 98. And in 1973 Fredrek Fraske, 101, died – the last army veteran to have fought against Indians (to quell a small rising in Idaho in 1894). France has awarded a Legion d' Honneur to every surviving Allied veteran of the first World War; some 3,000 survive in America.

LATE NOTES: Since July 24 the Dow at its recent high had gained 300 points. But the internal action of the market was weak. Lowry's Buying Power (which measures each day's upside volume and points) actually declined during the period from July 24 to the present. This was a very unusual, even surprising performance, and it shows that demand for stocks is very weak on any rally.

In fact, what we've been seeing is a rally based on weak buying power but even weaker selling pressure. This is not the formula for a strong, sustained rally.

On top of that we have the observation that during bear periods, the market tends to head down and hit a low during the fourth quarter of the year. Thus, in the face of the recent unimpressive rally plus the negative seasonal factor, subscribers should prepare for a period of potential weakness ahead.

NEXT MAILING: August 29, 2001